State of New Mexico
LEGISLATIVE FINANCE COMMITTEE

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LFC INVESTMENT REPORT FOR THE QUARTER ENDING MARCH 31, 2014

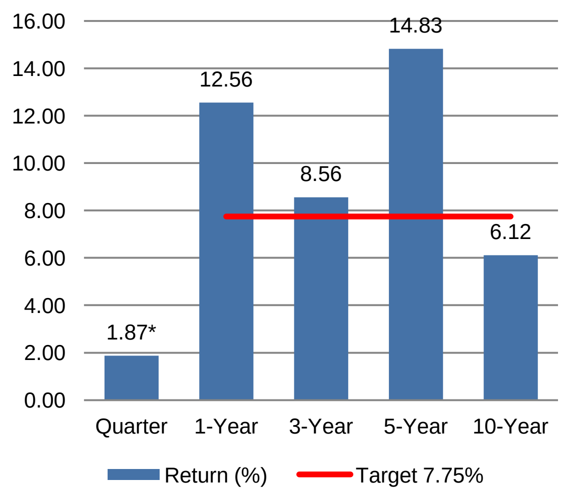
This report details the comparative investment performance of the three investment agencies: the Educational Retirement Board (ERB), the Public Employees Retirement Association (PERA), and the State Investment Council (SIC). It explains how the returns generated by these agencies differed from that of the archetypical fund and how their management and consultants added or subtracted value. Because long-term performance is an important metric, this report includes fund returns and comparative rankings for the one, three, five, and ten-year periods and attribution analysis for the quarter, one, and three-year periods.

Market Environment

- The U.S. stock market, represented by the Wilshire 5000 Total Market Index, rose 2.04 percent in the first quarter of 2014, surpassing the 1.81 percent return of the Standard & Poor's 500 Index and marking the seventh consecutive quarter of positive performance for U.S. equities;
- Public-market real estate stocks showed gains in the first quarter despite the harsh winter weather with lower interest rates providing support. The Wilshire U.S. Real Estate Securities Index returned 9.99 percent over the quarter, the strongest performers of the broad stock sectors as well as real assets in general; and
- The bellwether ten-year U.S. Treasury interest rate dropped from 3.04 percent to 2.67 percent from December 21, 2013 to March 31, 2014. Bonds in that maturity settled at 2.73 percent as of March 31, 2014. Yield on two-year U.S. Treasuries rose 6 basis points to 0.44 percent, while the thirty-year U.S. Treasury yield fell 40 basis points to 3.56 percent.

Returns and Ending Balances. Figures 1 through 3 show returns for the quarter and for the one, three, five, and ten-year periods ending March, 31 2014. The one, three, and five-year returns exceed the investment agencies' respective annual targets, which are 7.5 for SIC and 7.75 for ERB and for PERA. Ten-year returns reflect lesser investment performance because they are a function of adverse economic conditions and asset allocations that did not include alternative investments given policy restrictions imposed at the time.

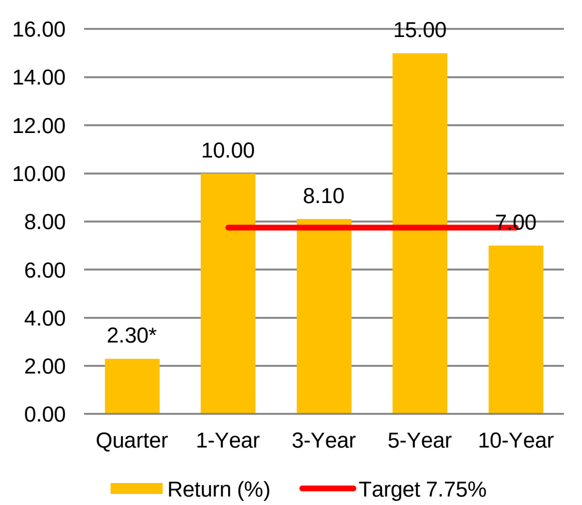
Figure 1. PERA Total Portfolio Returns
As of 3/31/14 - Ending Balance: $14.2B
(*Not annualized)



PERA’s investment policy establishes the fund's primary objective is to prudently invest assets in order to meet statutory obligations to its members. The fund's assets are managed to reflect its unique liabilities and funding resources, incorporating accepted investment theory, prudent levels of risk and reliable, empirical evidence. Specifically, PERA’s board has adopted the following principles:

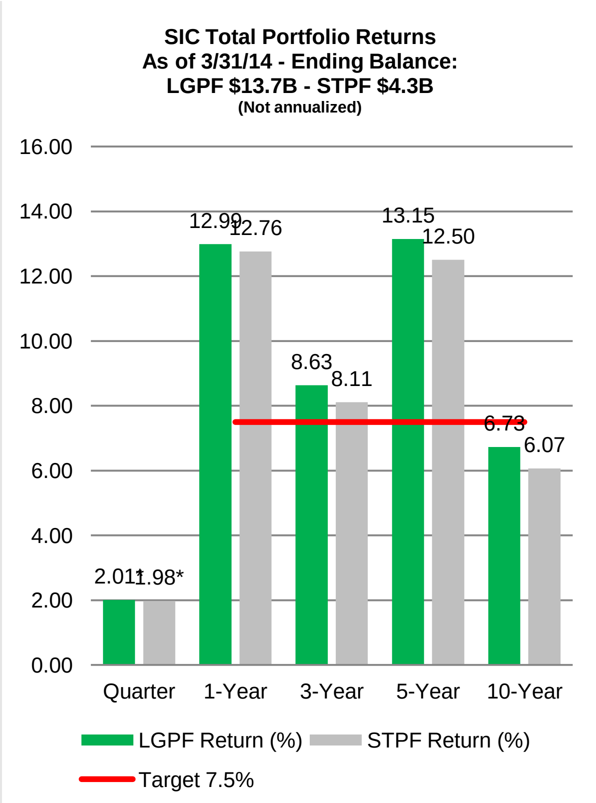
- Strategic asset allocation is the most significant factor influencing long-term investment;
- Risk is unavoidable;
- Diversification both by and within asset classes is the Fund's primary risk control element;
- The fund's liabilities are long term and the investment strategy must therefore be long-term in nature; and
- Sufficient liquidity will be maintained to meet anticipated cash flow requirements.

Figure 2. ERB Total Portfolio Returns
As of 3/31/14 - Ending Balance: $10.9B
(*Not annualized)



ERB’s investment philosophy and techniques are based upon a set of widely accepted investment models. The investment philosophy is summarized as follows:

- Develop and maintain strategic asset allocation targets and ranges that optimally attain objectives of return and risk;
- When appropriate, ERB seeks to profit from capital market inefficiencies and market dislocations that may occur periodically;
- Investment positions take trading costs into consideration;
- Monitoring of investments and asset managers is a good administrative practice;
- Performance measurement and attribution analysis are essential in assessing effectiveness of investment strategies; and
- Rebalancing of the fund’s assets is necessary for attainment of investment objectives.



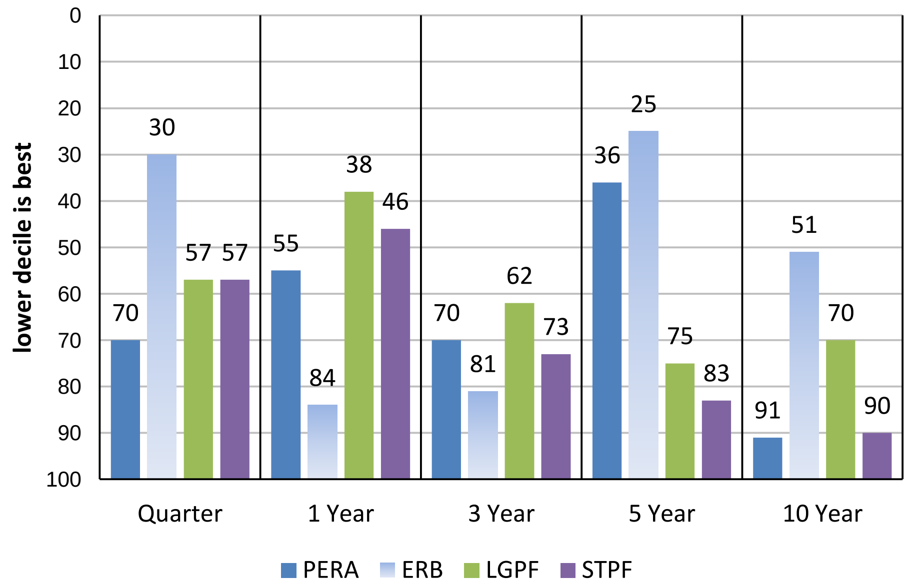
SIC invests the Severance Tax Permanent Fund (STPF) and the Land Grant Permanent Fund (LGPF), and its investment goals are to preserve the permanent endowment funds and to provide future benefits by growing the funds at a rate at least equal to inflation. SIC seeks to manage the funds to ensure that future generations receive the same or greater benefits as current beneficiaries, while maximizing current distributions through time to provide current revenue sources to the state's general fund. Total return, which includes realized and unrealized gains, plus income, less expenses, is the primary goal of the funds. In order to meet the investment objective, the SIC has adopted the following principles:

- Strategic asset allocation is the most important determinant of return variability and long-term total return;
- Risk is an unavoidable component of investing;
- Diversification by asset class and within asset classes is a primary risk control element;
- To preserve the purchasing power of the corpus and to provide benefits, the funds should have a long-term strategic asset allocation; and
- Sufficient liquidity will be maintained to meet the anticipated cash flow requirements of the funds.

The returns and balances of the STPF and LGPF are shown separately in Figure 3. A portion of the STPF is invested in economically targeted investments (ETIs) that typically perform below-market because the investments are not targeted solely at delivering returns. SIC, as authorized by the Legislature, can justify an ETI's reduced level of expected financial return, with the expected economic development benefits that the investment is expected to deliver. The LGPF does not have ETIs in its portfolio and so is a better gauge of SIC's performance. The difference in return between the two is a rough approximation of the opportunity cost of these initiatives.

Peer Total Return Rankings. Figure 4 shows peer total return rankings for the agencies' large funds for the quarter, one, three, five, and ten-year periods. A lower rank (1st is best) denotes better performance when compared to other public funds. These comparisons are made using the Wilshire Trust Universe Comparison Service (TUCS), a benchmark for the performance and allocation of institutional assets that includes approximately 75 public funds with more than $1 billion in assets.

Figure 4 - TUCS Universe Rankings as of March 31, 2014
(public funds > $1 billion)



Staff from all three investment agencies notes their respective performance rankings in the long-term are affected by limitations of their asset allocations at the time and by adverse economic conditions during the recession. That means before the agencies changed their investment policies toward diversified portfolios (through the use of alternative assets), the volatility of equity markets during the last 10 years had a larger effect on their returns. PERA adds, the returns for the 10 year ranking are tightly clustered with only 42 basis points separating the top quartile from the median fund and 48 basis points between the median fund and the 75th percentile. Further, House Joint Resolution 16 will put to the voters at the next general election a proposed amendment to strike the provision[1] that no more than 15 percent of the book value of the fund may be invested in international securities at any one time.

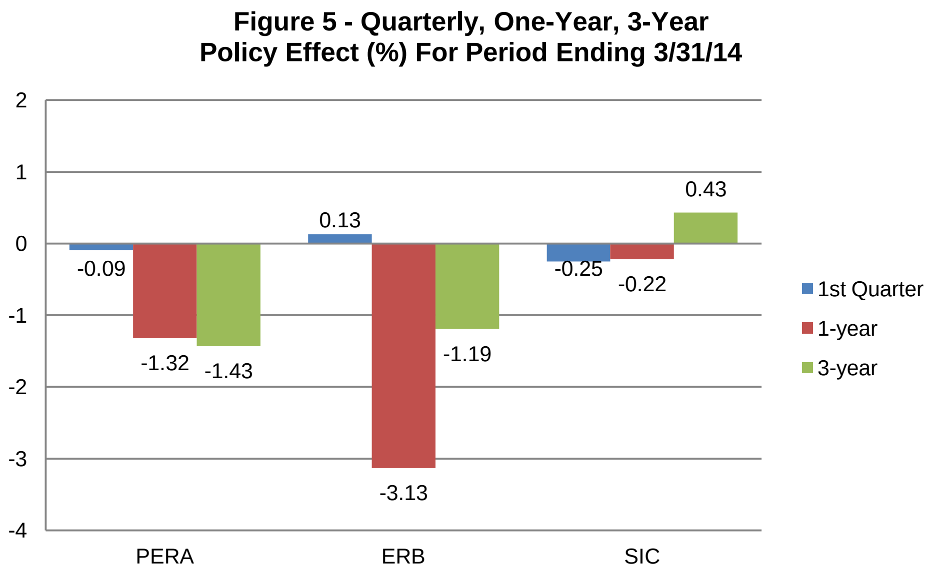
Attribution Analysis. There are three basic ways that a fund's returns can differ from the average: the policy, allocation, and manager effects.

Policy Effect. A fund can have a long-term policy allocation (known as the "policy index") target that has a more or less aggressive proportion of risky assets such as stocks. For instance, if risky domestic assets such as U.S. stocks (equities) performed well, an index that has more domestic equities should outperform the average. Measured in isolation, such a change in performance is known as the "policy effect," and it is an essential responsibility of the fund's trustees.

The most appropriate measurement of a policy allocation benchmark is a comparison to a defined peer group. Figure 5 shows the funds' policy effect as measured by comparing the funds' policy indices to the TUCS median fund actual return to allow uniformity and consistency across the three funds. The TUCS median return is gross of the allocation and manager effects, and the measure is therefore a rough estimate

[1] Article XII, Section 7 of the Constitution of New Mexico.

of the policy effect. (The investment agencies' policy target allocations are included in Figure 8, on page 9 of this report.)



PERA's policy index lagged the median fund by 0.07 percent in the quarter, 1.64 and 1.51 percent less during the one and three-year periods. PERA's Chief Investment Officer, Jonathan Grabel, recently announced that as part of a new asset allocation framework recently approved by their board, PERA will increase their alternatives exposure target (including private equity, hedge funds, real assets and real estate) from 20 to 23 percent.

The ERB's quarterly policy index performed 13 basis points above the TUCS median fund performance. The ERB notes the large effect for the one-year period is mainly due to the agency's lower policy weight in equities in general and particularly, in domestic equities, which performed well during the last 12 months, with the Russell 3000 and S&P returning 22.6 percent and 21.9 percent, respectively.

The SIC's LGPF investment policy calls for a 37 percent allocation toward domestic equities, and a 15 percent allocation toward non-U.S. equities. The SIC's policy index performed 25 basis points below the median fund in the quarter and in the one-year period with 22 basis points. The policy produced 43 basis points above the median fund in the three-year term.

Allocation Effect. The second way that a fund's return can be affected is by deviation from asset allocations called for by policy. As a matter of practice, investment officers are constantly confronted with allocation decisions when transitioning or rebalancing portfolio managers or asset classes.

Asset prices and values can vary in the short run, causing the allocation toward an asset class to drift from its long term target. Almost all rebalancing policies contain some flexibility for staff or the chief investment officer to operate within set boundaries. The three funds constantly see contributions coming in and distributions going out. Further, cash is being generated in some portions of the portfolio, and called or used in others, which can also cause asset allocations to deviate from policy. The investment officer may have the option of letting money sit in cash or incurring the cost of temporarily covering the allocation through the futures market or some other avenue, depending on policy authority. Rebalancing authority afforded the chief investment officer is dictated by investment policy, resulting in differing degrees of authority delegated by each fund.

The difference between the funds' temporary and long-term allocation is known as the "allocation effect" and is interpreted as investment return added or lost. Figure 6 shows the allocation effect graphically for the quarter, one-year, three-year, and five-year periods.

Figure 6 - Quarterly, One-Year, and 3-Year Allocation Effect (%) For Period Ending 3/31/14

PERA's asset allocation detracted 23 basis points during the quarter due primarily to an underweight in total fixed income and an overweight in international equities. For the one year period an overweight to domestic equities offset the negative effect of an underweight to private equity and an overweight in absolute return strategies. Asset allocation detracted 26 basis points for the three-year period with underweights in private equity and fixed income having the greatest impact. As PERA's allocation continues the transition from equity to a higher proportion of alternative assets, this underweight should decrease.

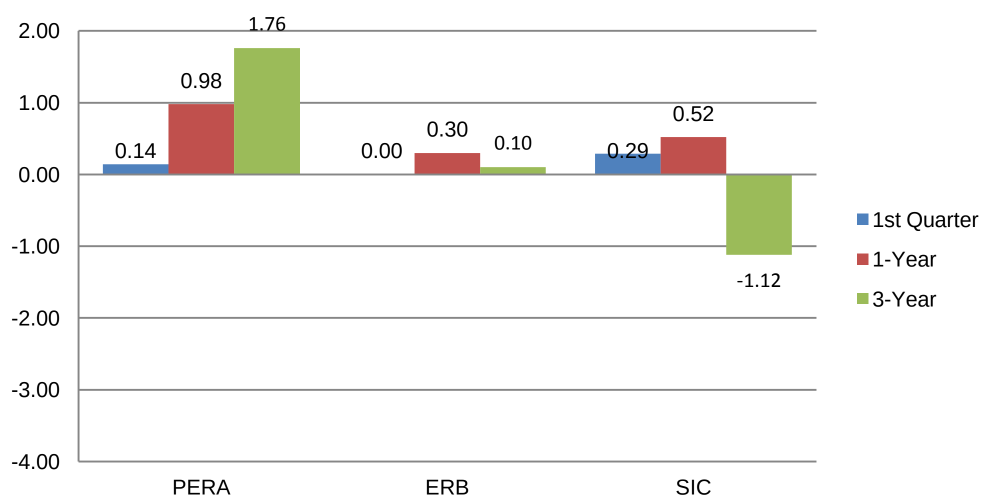
Like in the last quarter of 2013, ERB's first quarter of 2014 allocation effect was zero while their one-year results shows a positive 10 basis points. This resulted from value gained by deviation from allocation targets in U.S. equities and opportunistic credit, offset by a reduction in value due to an underweight in the private equity allocation.

During the quarter, SIC's return was 11 basis points below the median because of underweight to non-U.S. equity, private equity, real return and to real estate, which offset value lost due to overweight in private equity and fixed income. The one-year allocation effect for the SIC was -20 basis points. Value added by underweight to real estate, to real return, and to non-U.S. equity couldn't offset lost value from overweight to fixed income, U.S. equity, and cash equivalent assets. SIC notes that fund managers seek to minimize the magnitude of the allocation effect as deviations from policy do not tend to occur intentionally in an effort to increase returns. According to SIC, an over allocation to fixed income and cash equivalents hindered the portfolio, but overall asset allocation helped performance due to an overweight to US equity and underweight to non-US equity, real return, real estate, and private equity.

Manager Effect. The third way that value can be added or subtracted from a fund is through the use of active management. For instance, a fund can buy a security such as the institutional version of the Standard & Poor's Depository Receipts (SPDRS) commonly used by retail investors. These securities are composed of a relatively fixed basket of securities that track the S&P 500 index. Alternatively, the fund can employ a manager who will trade individual securities given his perspective of individual stocks. This is known as "active" investing. The difference between the return of the index and the portfolio of the active manager is known as the "manager effect."

Figure 7 shows manager effects for all three agencies during the quarter, one-year, and three-year periods. PERA's managers contributed to a quarterly manager effect of 14 basis points. The 98 basis points manager effect in the 1-year period was largely realized through allocation in domestic equities and absolute return. ERB's manager effect in the quarter was zero. The 1-year period remains unchanged from the previous quarter with 30 basis points because of offsetting gains in opportunistic credit and losses in global tactical asset allocation (GTAA). SIC's quarterly manager effect[2] show a gain of 29 basis points and their one-year period is 52 basis points. Value added in U.S. equity, fixed income, absolute return, and private equity assets did not offset value lost in non-U.S. equity and real estate for SIC.

Figure 7 - Quarterly, One-Year, and 3-Year Manager Effect (%) For Period Ending 3/31/14



<u>Passive vs. Active Total Portfolio Investment Management.</u> ERB, PERA, and SIC must make several decisions when implementing their respective investment policies. For instance, the policy must call for an asset allocation that appropriately diversifies the portfolio and balances risk and return. Agencies need to make decisions on how to implement the allocation, including whether to use an active manager or passively invest in an index.

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[2] The SIC notes that its net-of-fees performance analysis is based upon an estimate of SIC's investment performance developed by RVK.

Chief investment officers consider using active managers or investing in an index in an effort to maximize risk-adjusted net returns. In doing so, they use the concept of "Alpha" to measure the risk-adjusted returns of actively-managed investments. Alpha is the return in excess of the compensation for the risk borne and is derived from manager skill. The objective when deciding to engage in active management should be to generate enough Alpha to more than pay for the active management fees it costs to obtain. The active and passive distribution of all three investment agencies is described below using data as of March 31, 2014:

- Of PERA's approximately $7.9 billion in public equities, $3.8 billion (48 percent) is actively managed. However, this amount will change in the near future because PERA's investment policy was recently adjusted to reduce its equity allocation in favor of fixed income. Further, about $2.4 billion (95 percent) of PERA's alternative asset allocation is actively managed;

- Of ERB's approximately $4.1 billion in public equities, $1.6 billion (39 percent) are actively managed; in contrast, of the $3 billion invested in alternatives, $2.3 billion (76 percent) are actively managed. Further, ERB actively manages its entire $3.8 billion portfolio allocated in fixed income assets; and

- Of SIC's approximately $19 billion in assets between the LGPF and STPF, $15 billion (77 percent) is actively managed and of the $9.5 billion allocated to public equities, $5.1 billion (54 percent) is also invested by active managers. Further, SIC actively manages its entire investment allocation in the fixed income and alternative asset classes.

Figure 8 - Investment Agency
Strategic Asset Allocation Targets